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SUPERIOR COURT OF ARIZONA
MARICOPA COUNTY

TX 2004-000696 08/11/2006

HON. THOMAS DUNEVANT, III

CLERK OF THE COURT
S. Brown
Deputy

CALPINE CONSTRUCTION FINANCE COMPANY — PAUL J MOONEY

v.

ARIZONA STATE DEPARTMENT OF REVENUE, et al. — JAY C JACOBSON

UNDER ADVISEMENT RULING

Plaintiffs' Motion for Summary Judgment, Defendants' Cross Motion for Summary Judgment, and Defendant ADOR's Motion for Summary Judgment on its Counterclaim, as well as Defendants' two Motions to Strike have been under advisement. The analysis of all of the motions for summary judgment is identical.

The salient facts are that Plaintiff Calpine Construction Finance Company is the builder and operator of an electrical generating plant constructed on land leased from the Fort Mojave Indian Tribe. All parties acknowledge that the tribal land on which the facility is built is exempt from state taxation by federal law. They differ on the ownership of the improvements. The Arizona Department of Revenue and Mohave County (collectively, the "Defendants") assert that the improvements are the property of Calpine, which itself can lay no claim to the tribal exemption. Calpine contends that the improvements are in fact not its property, but the property of the Tribe and thus beyond the reach of the Defendants.

The District Court decision

As a preliminary matter, the determination of the District Court for the District of Arizona in CIV 02-1212-PCT-MHM that the improvements are Plaintiff's property does not have preclusive effect in this Court. Two elements essential to a claim of collateral estoppel are (1) that there be a final judgment and (2) that the party to be estopped have been a party to that judgment. Neither of those elements is found here.

Under Arizona law, collateral estoppel "attaches only when an issue of fact or law is actually litigated and determined by a valid and final judgment." *In re General Adjudication of All Rights to Use Water in the Gila River System & Source*, 212 Ariz. 64, --, 127 P.3d 882, 888 n.8 (2006). A proceeding stopped for whatever reason before a final judgment on the merits lacks preclusive effect. *Id*. The District Court held that it lacked jurisdiction over the Tribe's claim, and therefore was powerless to issue a judgment at all; the question of ownership of the improvements, while necessary to the District Court's analysis of the statutes governing its jurisdiction, was merely ancillary to the ultimate ruling. Issue preclusion exists only when the action of the first court serves as a bar to action by other courts. RESTATEMENT (2D) OF JUDGMENTS § 27, comment n. The only issue decided by the District Court with finality was whether it possessed subject matter jurisdiction. Unlike the federal courts, whose jurisdiction is limited by Article III of the United States Constitution and by federal statute, the Superior Court has jurisdiction in all cases which involve the legality of an Arizona tax. A.R.S. Const. Art. 6 § 14(2). No other issue was, or could have been, decided by the District Court. There is therefore no issue preclusion in this action. The Supremacy Clause of the United States Constitution does not obligate this Court to follow the statutory interpretation of the District Court. "[T]here is no dispute that the Arizona courts are the definitive expositors of Arizona state law." *Yniguez v. State of Arizona*, 939 F.2d 727, 736 (9th Cir. 1991). The Court thus applies its own analysis.

Calpine was not a party to the federal action; its petition to intervene had been denied by the District Court, on the ground that its claim was not cognizable in federal court under the Tax Injunction Act. *See* CIV 02-1212-PCT-MHM, Order filed March 31, 2004, at 3:4-5. The only claim before the District Court, then, was that the improvements were exempt from state taxation because they were owned by the sovereign Tribe, a claim with which Calpine plainly was not in privity. Calpine therefore cannot be estopped by the District Court ruling.

Defendants further seek to invoke against Calpine the theory of virtual representation, as set forth in *El Paso Natural Gas Co. v. State of Arizona*, 123 Ariz. 219 (1979). It is true that the same property was at issue in the federal action as in this one. Defendants argue that, because the District Court found that the Tribe did not own the improvements, Calpine *a fortiori* must. However, virtual representation can create *res judicata* only when there is a final judgment rendered on the merits by a court of competent jurisdiction. *Id*. at 222. Here, there was no final

judgment on the merits and the District Court itself held that it lacked jurisdiction. The requirements of *El Paso Natural Gas* are thus not met, and the doctrine of virtual representation cannot create *res judicata* against Plaintiff.

The lease under Arizona law

The interplay between sovereignty and the power to tax requires careful scrutiny of the property rights of the respective parties. Utilizing the traditional metaphor of property rights as a bundle of sticks is helpful. Initially, the fee simple owner holds all of the sticks, and the ability to tax the property depends entirely on the owner's status: if the owner is exempt, then all the sticks are exempt, otherwise all are taxable. If the owner decides to lease the property, he retains some sticks and transfers others to the lessee. If both parties to the transaction are subject to tax, it does not matter which of the sticks is deemed the critical one, as it will necessarily be held by a taxable party. If one party is exempt from taxation, however, and the tax regime imposes taxes collectively on the entire bundle rather than on each individual stick (as is the situation in Arizona), it will normally be in the interest of both parties that the exempt party retain the stick that establishes him as "owner." This will be true even if the economic context of the transaction requires that the attributes generally associated with the critical stick be transferred.

Arizona case law provides two tests of ownership. The first, enunciated by the Supreme Court in *City of Phoenix v. State ex rel. Harless*, 60 Ariz. 369 (1943), and reaffirmed in *Cutter Aviation, Inc. v. Arizona Dept. of Revenue*, 191 Ariz. 485 (App. 1997), focuses on the attributes. In this analysis, "'ownership' should be given a liberal construction in order to effectuate the legislature's objective. … 'The word "owner" has no technical meaning, but its definition will contract or expand according to the subject matter to which it is applied. As used in statutes it is given the widest variety of construction, usually guided in some measure by the object sought to be accomplished in the particular instance. [The] cases thus require us to interpret "ownership" by focusing on the context in which the term is used and on the legislature's objective in enacting the subject legislation.'" *Id*. at 490-91 (quoting *Harless, supra* at 377). The other, set forth by the Court of Appeals in *Maricopa County v. Novasic*, 12 Ariz.App. 551 (App. 1970), and also reaffirmed in *Cutter, supra* at 491, focuses on one particular stick, the reversionary right. Absent express language in the lease evidencing the lessee's ownership at the termination of the lease, the lessor is presumptively the owner of all improvements. *Novasic, supra* at 554-55; *Cutter, supra* at 491. Reconciling these two seemingly contradictory lines can be facilitated by the bundle of sticks analysis. Under *Novasic* and *Cutter*, the critical stick is the reversionary right. But under *Harless* and again *Cutter*, the Court must analyze, within the context of each case, what attributes make the reversionary right stick determinative of ownership, and whether those attributes have in fact been transferred from the exempt to the non-exempt party, regardless of the labels attached to each stick by the parties. Here, the Court must determine whether under

the terms of the lease there is a genuine reversionary right in the improvements that is retained by the Tribe.

Calpine's lease with the Tribe has an initial term of fifty years, with Calpine having an option to continue it for another fifteen years. During the lease period, the improvements are the property of Calpine. Calpine has the right to transfer the improvements and the water rights to another party; the Tribe is obligated not to unreasonably withhold its consent thereto. There are thus no significant restrictions on Calpine's right to control and dispose of the improvements for the duration of the lease. Calpine urges that the lease requires it to preserve the improvements in good order, thus denying it the right to destroy the plant. While the *Cutter* court stated that the right to destroy the property demonstrates ownership, *supra* at 491, it did not expressly state the converse, that absence of the power to destroy proves lack of ownership. The right to destroy is a right which holds more significance in property law theory than its relevance in real life can justify: no rational economic actor would destroy a multi-million dollar industrial facility merely because he has the right to do so. Therefore, the absence of that right weighs but little in the balance.

The State asserts, and Calpine does not appear to contest, that the improvements have an economic life of some thirty years at most; after fifty years, and certainly after sixty-five, their value will be essentially nil, even if they are kept in good repair and in a safe condition, as the lease requires. The lease requires Calpine to maintain the improvements in good repair, but all this means is that at the conclusion of the lease the Tribe will have fifty-year-old or sixty-five-year-old equipment. To look through the other end of the temporal telescope, it is as if the Tribe today took possession of 1940s or 1950s vintage power generating equipment. Even assuming that the equipment is still functioning, its usefulness would be virtually nil; it would be old and prone to breakdown, spare parts would be difficult if not impossible to obtain, and the cost of operation would be far greater than that of more current equipment in competing facilities. This distinguishes the present lease from those of buildings in *Novasic* and *Cutter*. Although buildings do lose some of their economic value as they age, the rate of obsolescence is far slower than that of productive facilities, which face the dual assault of wear and tear and technological advance. The lease permits Calpine to upgrade the improvements now in place with state of the art equipment as time goes on, and were it to do so that equipment would revert to the Tribe; but the lease does not require such modernization. It is Calpine's option to replace, repair, or simply allow the equipment to decline to a state of minimum functionality, and it must be assumed that Calpine will choose the option that maximizes its own profit, without regard to the future profit of the Tribe once it takes over the improvements. Thus, the possibility that the Tribe might in the end have improvements of a newer generation than the early 2000s cannot be considered an attribute of the Tribe's ownership.

To put the matter succinctly, unless Calpine decides otherwise, the terms of the lease insure that Calpine will receive one hundred percent of the productive value of the improvements over their lifetime. What will revert to tribal ownership at the conclusion of the lease is a husk exhausted of all economic potential. In no real sense does future ownership of this empty husk make the Tribe the owner of a multi-million dollar power generation facility. While the Tribe has formally retained the reversionary "stick," the parties have so structured the lease that this stick has been shaved down to a toothpick, leaving Calpine the rest of the bundle. *Harless* forbids, and *Novasic* and *Cutter* do not require, that the Court ignore the entire economic reality of the transaction and declare the toothpick alone determinative.

The Court finds helpful, though not controlling, the guidance provided by the United States Supreme Court in analyzing leasehold interests in the context of federal tax law. "[S]o long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes. What those attributes are in any particular case will necessarily depend upon its facts." *Frank Lyon Co. v. United States*, 435 U.S. 561, 584 (1978). Analytically, the Court must determine whether the formal allocation of rights under the lease transaction has economic substance beyond the creation of tax benefits. *Casebeer v. Commissioner of Internal Revenue*, 909 F.2d 1360, 1363 (9th Cir. 1990). The Supreme Court recognized that the structure of the lease may be "impelled by business or regulatory realities," and yet insisted that it be "imbued with tax-independent considerations." *Lyon, supra* at 583-84. This Court also recognizes that bona fide "sharing" of the benefits of a sovereign's tax-exempt status has long been employed in Arizona as a tool of economic development. *See, e.g., Maricopa County v. Fox Riverside Theatre Corp.*, 57 Ariz. 407 (1941). However, while the sticks may legitimately be allocated to take full advantage of the sovereign's tax exemption, the sovereign must preserve enough sticks to retain some significant and genuine attribute of its ownership. It cannot surrender everything but the bare title and use that title to cloak the lessee in its exempt status. Here, for the reasons stated, the Tribe's retention of the reversionary right, ordinarily a key indicium of the lessor's ownership, is so attenuated by the terms of the lease that it is no longer "significant and genuine." Nor has the Tribe retained any other significant attributes of ownership in the improvements.

Therefore, IT IS ORDERED:

1. Plaintiff's Motion for Summary Judgment is denied.

2. Defendants' Cross-Motion for Summary Judgment is granted to the extent that they seek a judgment that the improvements are subject to taxation by the State and Mohave County. There is still an issue as to the actual value of the improvements, so full summary judgment is denied.

3. Defendant ADOR's Motion for Summary Judgment on its counterclaim is granted.

Defendants' Motions to Strike

Defendants have filed their Motion to Strike Attachments A and B to Plaintiff's Motion for Summary Judgment and their Motion to Strike Exhibit A to Calpine's Combined Reply and Response. First addressing the former, Attachments A and B to Plaintiff's Motion for Summary Judgment are memorandum decisions of the Court of Appeals. The Arizona rule is that memorandum decisions are not to be cited, save in certain situations, none of which exists here. Ariz.R.Civ.App.P. 28(c); *Walden Books Co. v. Arizona Dept. of Revenue*, 198 Ariz. 584, 589 ¶ 21 (App. 2000). In particular, *Standage Ventures, Inc. v. State of Arizona*, 114 Ariz. 480 (1977), remains controlling with respect to their use to create offensive collateral estoppel. Moreover, Plaintiff's argument that these unpublished decisions create compelling or even binding precedent would hold this Court in every case relating generally to the issue of construction on Indian land to decisions whose holdings the Court of Appeals has not deemed worthy of publication. While this Court naturally welcomes instruction from the higher courts, it does not believe it appropriate to apply to this case analysis which the Court of Appeals chose to apply only to the specific cases before it and to which it may not have intended broader applicability. *See* Donn Kessler, *Memo Decisions: Online and Citable? Con*, ARIZ. ATTORNEY, June 2006, at 15.

Therefore, IT IS ORDERED granting Defendants' Motion to Strike Attachments A and B to Plaintiff's Motion for Summary Judgment.

Exhibit A to Calpine's Combined Reply and Response, a photograph of the South Point Energy Center, is not particularly enlightening, and its persuasive value is *de minimis*. While this attachment does not affect the Court's reasoning one way or the other of the case, Defendants are entitled to have it stricken.

Therefore, IT IS ORDERED granting Defendants' Motion to Strike Exhibit A to Calpine's Combined Reply and Response.